Financial Markets Commentary – 3/16/2020

by Robert G. Kahl, CFA, CPA, MBA

Got Toilet Paper?

It is obvious that there will be a negative impact on many sectors of the economy due to the COVID-19 virus. There have been widespread cancellations of sports events, youth soccer tournaments, book festivals, craft fairs, political debates, or anything where more than a small group of people will congregate. The numbers are not available yet but financial results in the first and second quarter are expected to be bad for airlines, cruise lines, hotels, and restaurants. International Paper is one of the few companies that may benefit due to an inexplicable run on toilet paper.

Prior to the recent turn of economic news, economists were expecting US GDP growth of 1.5% for the first quarter. Goldman Sachs has revised their US GDP forecast to zero growth for the first quarter, negative 5% contraction in the second quarter, and growth of 3-4% in the third and fourth quarters. Goldman Sachs acknowledged that their forecasts now have a higher degree of uncertainty.

Jeff Gundlach, the CEO of Doubleline Funds, has said in past webinars that the federal budget deficit will probably expand to $2 trillion during the next recession. His comments seemed to be based upon the normal decline in tax revenue that we see during a recessionary period. Given the tax cuts and additional spending programs currently being proposed in response to the COVID-19 recession, the magnitude of the budget deficit may become alarming.

Irresponsible Corporate Financial Behavior Exposed

The COVID-19 pandemic has exposed the financially aggressive and irresponsible policies of some companies. Two examples are American Airlines and Boeing, both of which had negative shareholders equity as of December 31, 2019.

Name	Symbol	Total Liabilities ($B)	Shareholders Equity ($B)	Net Income Last 12 months ($B)	Times Interest Earned
American Airlines Group Inc	AAL	60.1	-0.1	1.7	3.5
Boeing Co	BA	141.9	-8.6	-0.6	not earned

Both companies issued substantial amounts of debt during the last decade and used the proceeds to buy their own shares, while paying a dividend to shareholders. American Airlines and Boeing returned so much cash to shareholders via the share buybacks and dividends that both have negative shareholders equity. Given the low level of interest rates, this was considered to be an efficient use of capital. This is one example of how the Federal Reserve's policies have promoted instability in the financial system. COVID-19 will impact both businesses more than most and it is likely that both companies will require some type of financial assistance from the federal government.

Oil Market Disruption

A week ago, during the weekend, Saudi Arabia met with other OPEC members and allied producers such as Russia. Saudi Arabia and Russia were unable to agree on a lower level of production. After the meeting, Saudi Arabia announced that they would increase oil production by 2.6 million barrels per day despite a reduction in global demand caused by the COVID-19 outbreak. While Russia sought to allow producers to make their own production decisions, Saudi Arabia wanted to establish control over production levels of the major producing countries. Saudi Arabia's announcement of a higher production level resulted in the largest price decline for crude oil in a single day since 1991.

Russia has a relatively low cost for much of its oil and gas production. However, US oil and gas exploration companies that rely on fracking technology and the issuance of large amounts of debt to finance their exploration are in serious jeopardy. The bonds of many of these companies are in the process of receiving credit downgrades and are trading at much lower price levels.

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The Fed is on it!

The Federal Reserve has taken dramatic action in response to the COVID-19 economic contraction. On Sunday, the Federal Reserve cut the fed funds interest rates by a full percentage point to near zero and said it would buy $500 billion of US Treasury securities and $200 billion of mortgage-backed securities in coming months.

Last Thursday, the Fed announced that they would substantially increase their repurchase agreement (repo) facilities to $1.5 trillion by the weekend and an additional $500 billion per week for the remainder of the monthly schedule. Repurchase agreements are essentially short-term collateralized loans with US Treasury or Agency securities submitted as collateral. These repo facilities have not been fully utilized by the banks and brokerage firms, but it is certainly a statement of how far the Fed is willing to go to support financial markets.

After both Fed announcements, the stock market has sold off sharply. Perhaps investors thought that if the Fed is taking actions that are much larger in scale compared to the financial crisis of 2008-2009, something must really be wrong. This reaction is probably not what the Fed anticipated but so be it.

Precious Metals

Given the low level of interest rates, global economic contraction, and aggressive monetary policy of the Fed, one would normally expect precious metals to do well in this environment. When the stock market first began to sell off a few weeks ago, precious metals appeared to be a safe haven and prices rose on many days when stock prices declined. Things changed last Thursday.

The Fed's announcement regarding the expansion of its repo operations was accompanied by massive sell orders prior to the open of the COMEX (when trading volume is limited). In the futures markets, this momentum has continued during the last two business days.

The Gold Anti-Trust Action Committee (GATA) has long maintained that the US Government construes the Gold Reserve Act of 1934, as amended, to establish the Treasury Department's Exchange Stabilization Fund and authorizes it to intervene and manipulate any market in the world. Statements by the US Attorney's Office and regulators seem to support this view.

Craig Hemke, an analyst with Sprott Asset Management, has chronicled the use of "exchange for physical"(EFP) transactions to satisfy COMEX obligations. Prior to the maturity date of many COMEX contracts for gold and silver, the obligations are fulfilled by exchanging the COMEX contract for a contract for delivery of physical metal in London. For the seven business days from February 28 thru March 9, EFP transactions for 390.5 metric tonnes of gold took place. This amount exceeds the gold reserves of the United Kingdom which has 310 metric tonnes. Furthermore, Hemke calculates that the amount of COMEX gold contracts that have been satisfied by EFPs with London delivery during the last two years exceeds 14,000 metric tonnes. This amount far exceeds any known supply sources and these contractual obligations for delivery will eventually fail. Hemke's full article can be read here: https://www.sprottmoney.com/Blog/comex-gold-efp-use-surges.html .

Some contrarian investors have not jumped in line with the futures markets for precious metals. US Mint silver eagle sales have jumped dramatically and depleted the US Mint's silver inventory. March month-to-date sales of silver eagle coins at the US Mint are more than 300% higher than sales for the entire month of February. Sales of gold eagle coins are also higher than February. Many of the US Mint silver and gold coin products are currently unavailable even though they are sold at a significant premium to spot bullion prices.

Despite recent price action, I believe it makes sense to include gold and silver bullion in an investment portfolio. Looking at economic history, precious metals have always served as a safe haven during hyperinflationary periods. There are no exceptions. And current US fiscal and monetary policies are putting us on a path to hyperinflation.

What Next?

The emphasis on high credit quality fixed income in most portfolios has served us well but it is losing its relative attraction. During the next few months, I expect to increase the allocation to equities within the parameters allowed by the current investment guidelines.

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Selling of common stocks has been indiscriminate. Some stocks such as Walgreens, Molson-Coors, BT Group (British Telecom), and Unum (group disability and life insurance) are not likely to experience much negative economic impact but have sold off with the rest of the market. Other stocks may experience some negative financial impact during the first half of the year, but their balance sheets are strong, the risks are already priced into the stock, and the potential for price recovery is high. Some selected stocks now sell at attractive valuations with dividend yields that are very high relative to fixed income alternatives.

Depending on how the economy and financial markets develop, I may be contacting you in the future to recommend a revision of investment guidelines to include a higher allocation to equities. In the meantime, my cats remain unperturbed.

If you have any questions or comments, please contact me.

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